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The state of retail banking: Profitability and growth in the era of digital and AI

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Executive summary

Retail banks around the globe are coming out of a period of strength. When governments stimulated economic growth during the COVID-19 years, banks benefited from increased consumer savings and reduced levels of credit risk. Then, starting in 2022, rising interest rates expanded net interest margins as interest income on loans grew faster than the cost of deposits. As a result, returns on equity (ROEs) for the broader global banking sector in 2023 reached their highest point since the 2008 onset of the global financial crisis: roughly 12 percent, according to McKinsey Panorama, up from 10 percent between 2013 and 2020.

Looking ahead, retail banks face three major headwinds: cost inflation, significant escalation of the occurrence and sophistication of fraud, and uncertainty about interest rates. These forces will limit asset growth, compress margins, and increase costs for banks. At the same time, the continuing rise of consumer expectations and a weakened but still competitive fintech sector are adding competitive pressure to the mix.

However, these forces are not something banks never previously faced in some form or another. To counter them, banks will focus on two fundamental imperatives: *doubling down on primary relationships* and *protecting margins.* In our view, banks will pursue these goals with a combination of traditional levers—for example, improving branch effectiveness—and next-generation capabilities such as digitization, AI, and generative AI (gen AI).

In an environment in which the cost of deposits has increased and liquidity has become a key constraint (over the past two years), banks will need to focus on building deep and lasting relationships with valued customers. Customers with primary relationships to a bank not only keep most of their deposits there but also are open to additional products and services that boost banks' fee income. Banks have also faced regulatory headwinds in terms of fees; if this trend continues, it will be even more important to increase the value of each customer.

To develop and deepen customer relationships, banks can offer an array of incentives, introduce one-to-one personalized experiences, and refine their channel distribution strategies. Our recent research shows that the channel landscape is shifting. Branches continue to play a role in customer acquisition and advice, but mobile is now the gateway to everyday banking for a growing majority of consumers in various markets. Banks therefore need to design their distribution so it leads with mobile.

Relatedly, banks continue to invest deeply in technology, even as they realize it will not be easy. Banks are still struggling to realize significant revenue or cost benefits[1] from technology investments. Successful institutions will focus on protecting margins through targeted investments in digitization and AI, including gen AI, to improve pricing, mitigate losses, control operating costs, and increase productivity. AI and gen AI in particular will be instrumental in the development of next-generation deposit capabilities.

Finally, as fraud losses mount, retail banks must find a nuanced approach that contains and reduces fraud losses without drastic reductions in revenue.

As market conditions become more challenging and the competitive environment shifts, the moment is fast approaching when banks will need to revamp their strategies and execute with precision. Leading institutions will set a course rooted in the basics of deeper customer relationships and superior operating efficiency, enabled by strong investments in digitization and the use of AI and gen AI.

[1] *Baking & Securities matters,* "For banks to demonstrate value from tech and AI, they will need to reach beyond the CIO's office," blog entry by Ido Segev and Vik Sohoni, McKinsey, July 1, 2024.

1. The state of global retail banking

The last few years have been among the most successful in the recent history of retail banking, with a confluence of macroeconomic trends driving growth and profitability. In some geographies, pandemic-era government stimulus lifted economic growth, fueled consumer spending, created favorable conditions for balance sheet expansion, and helped keep credit risk in check. Following the pandemic years, rising interest rates improved banks' net interest margins as loan interest grew faster than the cost of deposits.

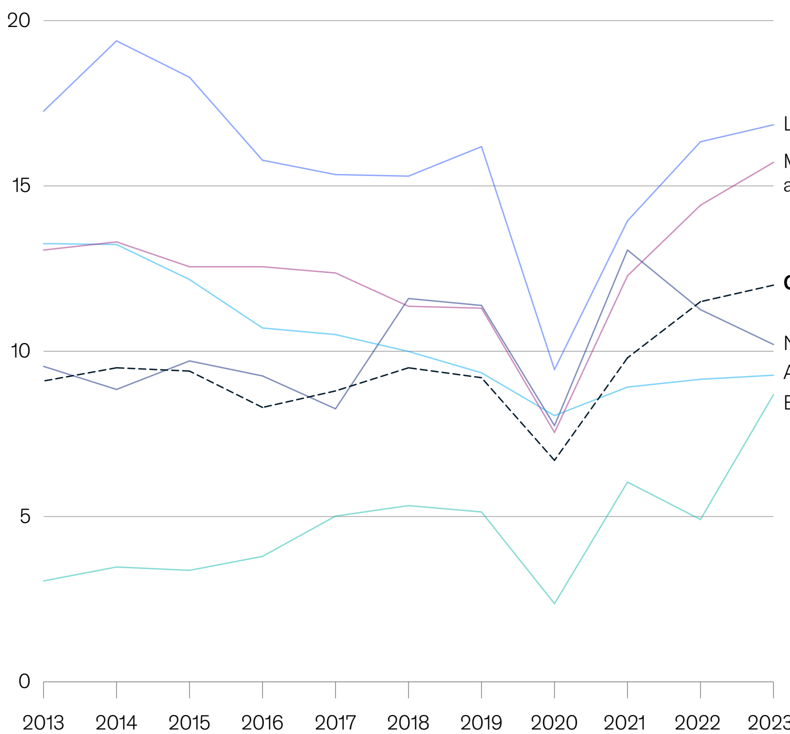
Globally, according to McKinsey Panorama, banking[1] ROEs have reached their highest point since the onset of the global financial crisis, roughly 12 percent in 2023 (Exhibit 1), significantly outperforming recent historical averages, including the roughly 9 percent average the industry experienced in 2013–20. Latin America, the Middle East and Africa, and Emerging Asia (excluding China) led, with up to 17 percent ROE for 2023, followed by North America at 10 percent and Developed Asia, China, and Europe at up to 9 percent.

[1] Includes corporate banking, investment banking, and retail banking.

Exhibit 1

Banking return on equity has exceeded prepandemic levels in recent years.

Return on equity,[1] %



	Period averages, %	
	2013–20	2021–23
Latin America	15.9	15.7
Middle East and Africa	11.8	14.1
Global	**8.8**	**11.1**
North America	9.5	11.5
Asia–Pacific	10.9	9.1
Europe	3.9	6.5

[1] Return on equity defined as net income/total equity.
Source: McKinsey Panorama, McKinsey Value Intelligence, S&P Capital IQ

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In 2023, the global retail banking market also surpassed the $3 trillion revenue mark on the back of sustained growth of about 8 percent annually in recent years (Exhibit 2). The positive performance has been geographically broad. Revenue growth accelerated in Europe (8.7 percent CAGR for 2020–23, versus 1.5 percent CAGR for 2013–20), Developed Asia (7.0 percent versus 3.3 percent), Emerging Asia excluding China (11.2 percent versus 6.9 percent), Latin America (19.0 percent versus 10.3 percent), and the Middle East and Africa (10.0 percent versus 4.4 percent), driven by higher interest rates and increasing financial inclusion. North America has shown stable growth of 5 to 6 percent throughout, whereas China's retail banking revenue growth slowed from 11 percent to 3 percent, primarily due to weaker economic expansion.

A turning point

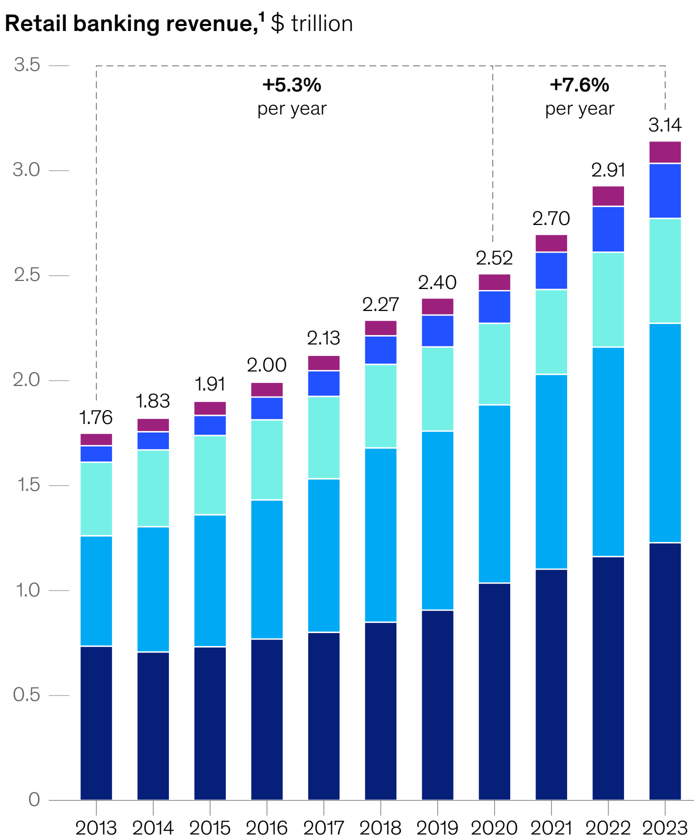
The outlook for global retail banking is more muted than its recent performance would suggest. External forces are combining to pressure the sector in the key economic metrics of asset growth, margins, and operational and risk costs.

Intensifying competition for deposits

In 2022, following a long period of deposit growth driven particularly by favorable fiscal and monetary

Exhibit 2

Retail banking revenue growth has accelerated in recent years across most regions.



	CAGR, % 2013–20	2020–23
Middle East and Africa	4.4	10.0
Latin America	10.3	19.0
Europe	1.5	8.7
Asia–Pacific	7.0	6.7
North America	5.0	5.8

Note: Figures may not sum to listed totals, because of rounding.
[1]2023 retail banking revenues based on partial-year estimates in certain regions.
Source: McKinsey Panorama—Global Banking Pools

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policies through 2021, deposits started to decline (North America) or their growth decelerated (most other regions)[2] as governments around the globe tightened monetary policy and moderated fiscal policies (Exhibit 3). Looking forward, banks are expecting the higher-interest-rate environment to continue despite some recent and—potentially—upcoming reductions in interest rates by central banks. In a recent survey by the McKinsey Global Institute, two-thirds of senior banking executives shared that they expect some form of high-interest-rate scenario. This implies a longer-term environment of positive real interest rates, in which nominal interest rates are higher than expected inflation, and a period of quantitative tightening with a more limited money supply. Given these trends, we still anticipate that deposit growth will remain sluggish for retail banks and that central banks will continue to limit the growth of their balance sheets for the foreseeable future—or in some countries even shrink them.

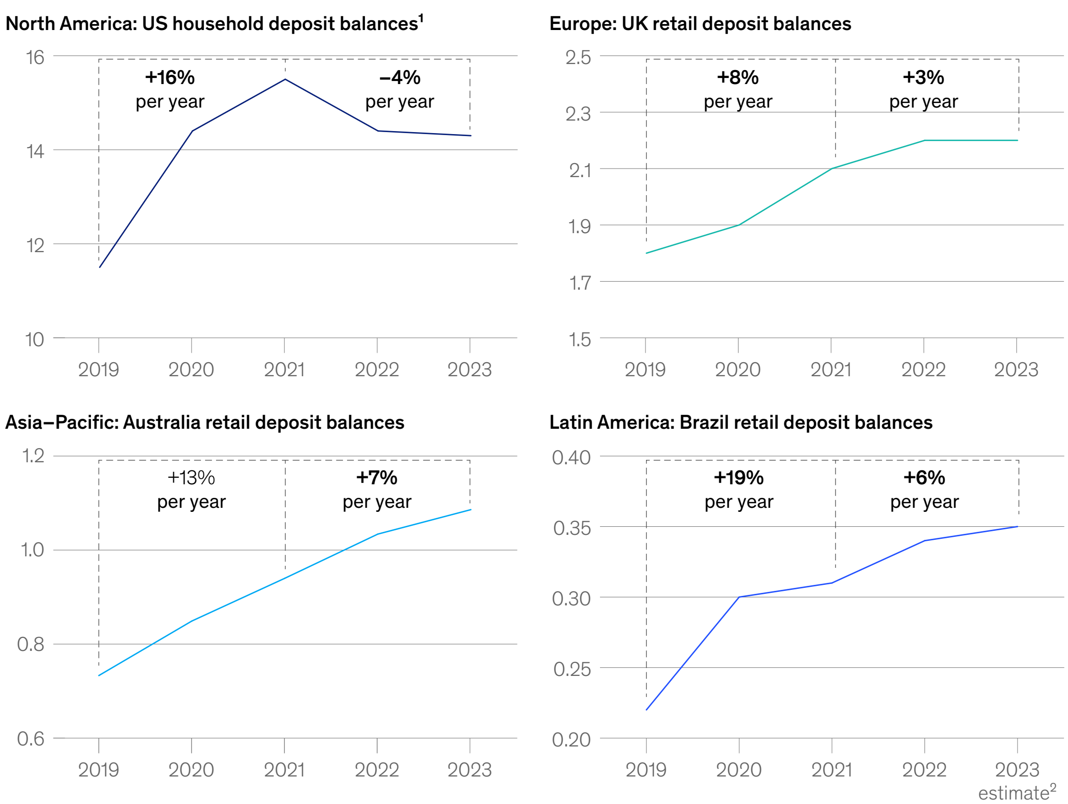
The interest rate environment not only has an impact on deposit volume but also affects the mix

[2] McKinsey Panorama.

Exhibit 3

Growth of retail banking deposits has significantly slowed in high-interest-rate environments.

Deposit balance examples,[1] $ trillion



[1]For United States, total household and nonprofit deposit balances are used as a proxy for retail deposits.
[2]Brazil 2023 retail deposits are estimated based on partial-year actuals for the 1st half.
Source: Federal Reserve Economic Data; McKinsey Panorama—Global Banking Pools

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of deposit classes. Consumers are adding to their fixed-term deposit accounts, which grew from 34.2 percent of total deposits in 2021 to 39.6 percent in 2023 globally, according to McKinsey Panorama. We expect this trend to continue, further intensifying banking competition for consumers seeking deposit yield while increasing cost of funds.

The interest rate landscape is a challenge but represents an opportunity for banks that reconsider—or reinvent—how they compete for deposits. In our experience, few have taken steps to reconsider their branch strategy or bolstered their analytical capabilities to upgrade their deposit-gathering approach in a highly price-sensitive and relationship-driven arena.

Pressure on revenue margins

Over the last two years, as interest rates increased, retail banks have seen their margins peak. However, intensifying pressure on fees and interest revenue from regulatory headwinds and the expected ongoing lowering of interest rates, respectively, will compress bank margins. Deposit betas are catching up with lending betas, and some central banks have already started to reduce rates. For example, the European Central Bank cut interest rates in June 2024 for the first time since 2019 and followed up with another cut in September. The US Federal Reserve followed on September 18 with its first cut since March 2020. These actions will lead to steady margin contraction for retail banks as lending rates begin to drop faster than cost of funds.

Interest margins are likely to account for the bulk of margin contraction facing retail banks—roughly 70 percent through 2026, with some variance across regions. If regulators continue to closely monitor and intervene in bank activities and offerings, particularly fees for mass-market products and services like credit cards, overdrafts, and deposits, margins will face additional downward pressure. At the same time, fintechs with low-cost business models continue to erode banks' fee revenue, particularly in regions with deeper fintech penetration, like Latin America (see sidebar, "Fintechs: Still in the game").

The impact of these headwinds on retail banking margins will, of course, vary by region, but the trend is globally consistent. We anticipate margin declines of between 5 and 10 percent by 2026 across various geographies.

Rising costs

Operating costs for retails banks are increasing (Exhibit 4), driven by four trends: wage growth, increased occurrence and magnitude of financial crimes, rising imperatives for technology investments, and growing credit risk. This confluence of trends will force banks to reenvision how they manage cost productivity in the coming years.

Wage growth is catching up with general inflation in several regions. In Europe, it was 3.8 percentage points higher in 2023 than it was in 2019. In North America, it was 0.7 percentage points higher.[3] In Asia–Pacific, wage growth since the pandemic has remained at high levels similar to those in the period leading up to the pandemic. As labor costs continue to rise, banks will need to raise salaries to compete for digital and analytics talent as well as other scarce resources (wealth advisors, for example). It will be critical for banks to actively monitor the impact of these increases on their overall cost base.

Unsurprisingly, banks' technology budgets have grown much faster than their other costs as they make necessary investments in digitizing and incorporating AI into their business models. Globally, IT accounted for 20 percent of total expenses in 2022, compared with 14.8 percent in 2018, according to the McKinsey IT Spend Benchmark. As banks migrate demand from physical to digital channels, they need to develop the discipline to cut costs in distribution and operations. This will increase the ROI of tech investments while creating a digitization flywheel that allows efficiencies to be reinvested into further digitization.

Also, financial crime is on the rise, according to McKinsey's 2023 Fraud Survey and other public sources,[4] as is fraud's contribution to banks' losses and operational expenses. The scale of the problem

[3] Economist Intelligence Unit.
[4] McKinsey Fraud Survey 2023; US Federal Trade Commission (FTC) Consumer Sentinel Network; and Verafin 2024 Global Financial Crime Report.

Fintechs: Still in the game

The tightening global macroeconomic environment has been a challenge for fintechs and digital retail banking attackers. In the core pandemic years, fintechs benefited from easy access to funding—receiving, for example, $92.3 billion in venture capital investment in 2021. However, amid rising interest rates, this trend has normalized, with 2023 venture capital funding decreasing by 63 percent in absolute terms to $34.1 billion. (Still, these funding levels are in line with pre-COVID-19 figures—for example, $36 billion in 2019.)[1]

While fintech funding woes have alleviated some of the competitive pressure on banks, it is far too early to declare the fintech disruption over. Many fintechs have already established strong footholds. NuBank, for example, announced it had reached the 100-million-user mark in May 2024. And in the United Kingdom and Northern Europe, fintechs like Revolut and Klarna, respectively, have been able to break through and build strong brands with customer loyalty.

Fintechs are also making inroads in select retail banking value pools, capturing revenue from niche service lines and deploying new business models. While these gains may seem minor in the broader scheme of things, the pressure threatens the status quo of the universal banking model and raises the specter of death by one thousand cuts, whereby attackers capture one pocket of profits after another.

In the United States, for example, according to the McKinsey Global Payments Map, digital attackers such as Square, Stripe, and Toast have already captured roughly 34 percent of total merchant services payment revenue by developing customer-centric solutions tailored to micro and small merchants, which now increasingly turn toward these players (and not the nearest bank branch) for their payments needs. A similar trend can be observed in global remittance flows. In 2014, 38 percent of flows went through retail bank branches (and 58 percent overall through retail banks). Once fintechs like Remotely and Wise entered the arena, offering more affordable transfers, these numbers declined significantly. Currently, only 18 percent of remittances flow through retail bank branches, while 31 percent flow through nonbank digital channels (versus 8 percent in 2014), according to McKinsey's Global Payments Map. Writ large, this kind of niche market dominance could spell deeper competitive trouble for banks.

Many of the trends that led to the early success of fintechs are still in place: digital-native consumers continue to age and amass wealth while younger consumers favor low- or no-fee offerings, making the playing field more challenging for incumbents with more traditional fee-based models. Moreover, as banks in some developed economies have greater difficulty serving mass-market clients profitably, fintechs with their lower marginal costs are finding fertile ground in such markets. In addition, consumers of all levels are increasingly banking with more institutions; for example, according to the McKinsey Global Consumer Survey, the average number of total banking relationships per consumer in the United States increased from 2.6 in 2021 to 3.2 in 2023. As a result, individual banks struggle to generate sufficient revenue per customer to overcome a higher cost to serve.

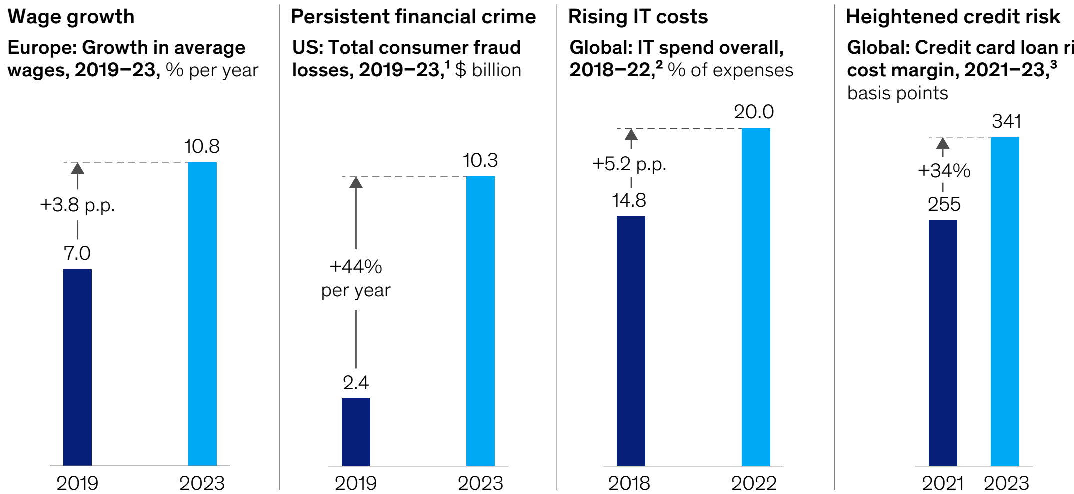
As the case has been from the beginning of the fintech era, traditional retail banks' long-term competitive success will continue to rely on the depth of their relationships with customers and the ability to serve them at low cost.

[1] Dealroom.com.

Exhibit 4

Retail banking costs are rising on multiple fronts, increasing cost to serve.

Select examples of increasing banking costs



[1]Federal Trade Commision (FTC) reporting of consumer fraud losses does not reflect magnitude of losses incurred by financial institutions.
[2]Insights on IT spend reflect ~200 data points from banks across the world, collected by proprietary McKinsey benchmarking solution (Ignite) since 2013.
[3]Risk cost margin reflects impairment that banks provision as a % of average outstanding loans to account for bad debt. Figures are captured in terms of basis points to enable comparison.
Source: Economist Intelligence Unit; US FTC Consumer Sentinel; McKinsey Ignite IT Spend Benchmarks; McKinsey Panorma—Global Banking Pools

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is growing. In the United States, reported consumer fraud losses have grown at a 44 percent CAGR since 2019.[5] Meanwhile, 60 percent of financial institutions in Latin America reported an increase in fraud in the last two years.[6] In the United Kingdom, authorized push payment fraud has increased 14 percent per year, with reimbursement rates likely to grow by 40 to 60 percent at industry level in light of new regulation from the Payment Systems Regulator.[7]

Not only the scale of fraud is expanding, but also the level of sophistication, which leaves banks struggling to respond comprehensively and consistently. When one version of fraud is addressed or managed, another tends to arise in its place. For example, multifactor authentication has helped mitigate account takeover fraud, but new scams (for example, elder scams and invoice scams) have stepped in to fill the void. The significant growth in fraud is particularly painful for smaller banks, as it inflicts disproportionate damage on their more modest balance sheets.

Retail banks need a balanced approach to fighting fraud, one that addresses the problem without drastically reducing revenue. However, most banks have yet to develop a holistic, end-to-end fraud-fighting approach that encompasses detection, prevention, and resolution. Instead, many are tightening controls across the board without nuance, while others develop one-off solutions for discrete challenges, such as check fraud. Mastering fraud is becoming as critical for digital banking as superior credit capabilities have been for traditional banking.

[5] US FTC Consumer Sentinel Network.
[6] McKinsey Fraud Survey 2023.
[7] UK Finance fraud reports.

Banks are also facing an uptick of credit risk, which is approaching early pandemic (2020) levels (Exhibit 5). Government stimulus helped contain major delinquency risk throughout the core COVID-19 period, but credit risk provisions (see the increase of 86 basis points in credit card risk provision between 2022 and 2023) and delinquencies across consumer asset classes have been rising as the effect of the COVID-19 stimulus wears off. While banks are making impairments to price in this elevated credit risk, risk costs are creating additional pressure on top of other operating cost headwinds.

Finally, the increase in regulatory oversight and scrutiny, particularly after the liquidity crisis that resulted in the collapse of some major US and European banks, is creating an additional cost constraint on banks. Expected new capitalization requirements are likely to further increase the cost of capital, while the additional administrative requirements that accompany more oversight are causing many banks to expand their risk and compliance capabilities.

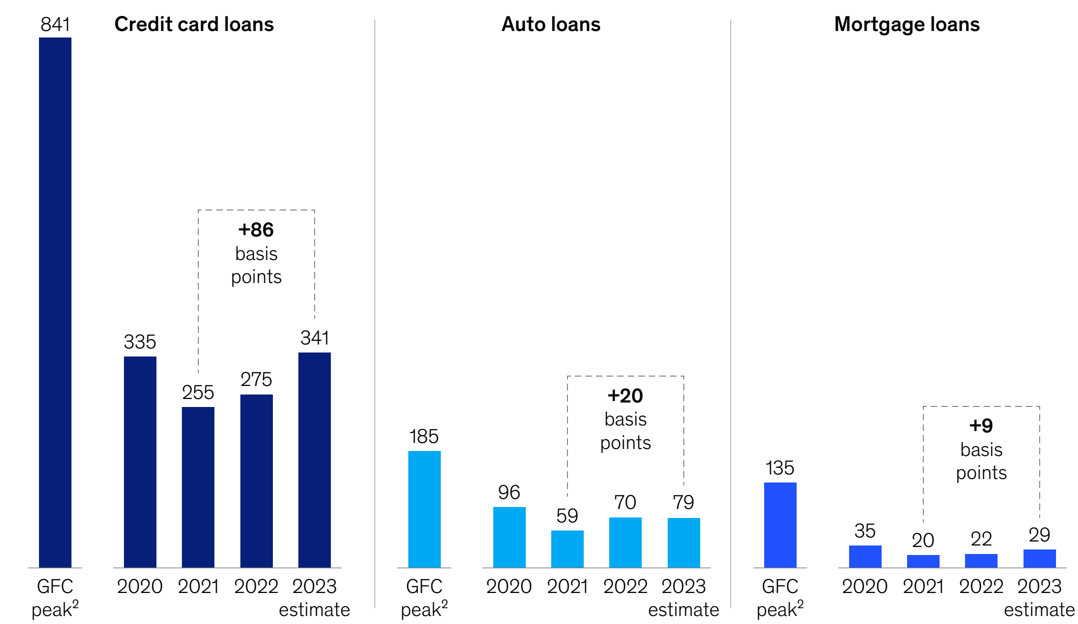
Repositioning

Considering the outlook of revenue margin compression (under pressure from deposit headwinds) and increasing costs, investors are rewarding banks' ability to generate high-ROE fee-based revenue and lower their cost of funds (Exhibit 6). Our analysis of more than 100 North American banks indicates that cost of funds and non-interest income correlate closest with overall valuation multiples (specifically, price to tangible book value, or P/TBV).[8]

[8] S&P Capital IQ.

Exhibit 5

Banks are provisioning higher risk costs—approaching 2020 levels.



[1] Risk cost margin reflects impairment that banks provision as a % of average outstanding loans to account for bad debt. Figures are captured in terms of basis points to enable comparison.
[2] Peak levels from global financial crisis (2007–09).
Source: McKinsey Panorama—Global Banking Pools

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Exhibit 6

Investors are rewarding banks' ability to generate high-ROE fee-based revenue and low cost of funds.

US example: Statistically significant drivers of P/TBV[1]

Top 2 drivers [+] Positive correlation [–] Negative correlation

		Parameter impact	Improvement in P/TBV from bottom quartile to top quartile
Revenue growth, FY 2024–25E[2]		Revenue growth, % [+]	0.07
Return on tangible equity (ROTE) drivers, FY 2023	**Net interest margins**	Earning asset yields,[2] % [+]	0.22
		Cost of funds,[3] % [–]	0.30
	Fee income	Non-interest income, % of tangible assets [+]	0.37
	Efficiency	Operating expense, % of tangible assets [–]	0.15
	Asset quality	Loan loss provisions, % of loans [–]	0.07
Balance sheet, FY 2023	**Loans and deposits**	Loan-to-deposit ratio, % [–]	0.07
		Commercial and commercial real estate loans, % [–]	0.11

[1]Price to tangible book value. Analysis based on 112 US banks with total assets >$10 billion. P/TBV priced as of Mar 11, 2024.
[2]2025 estimate.
[3]Earning asset yields and cost of funds are based on latest quarterly data (Q4 2023). Earning assets include loans and investments in financial markets.
Source: S&P Capital IQ; McKinsey analysis

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In other words, in an environment where interest rates are elevated but a high degree of uncertainty surrounds the pace at which central banks will manage rates down, investors are rewarding banks that can acquire granular, sticky, and low-cost deposits; build stable fee-based businesses that are more resistant to external and macro forces; and offset the likely decline in interest margins. Such businesses include, for example, wealth management, cards, and other payments products.

To a lesser extent, cost efficiency also is a major driver of valuation for banks. Achieving and maintaining cost efficiency will require banks to invest in next-generation strategies effective at protecting their margins.

2. Winning strategies for a shifting banking landscape

A landscape shaped by cost pressures and revenue margin compression calls for banks to focus on dual imperatives: doubling down on primary relationships and investing in technology and analytics capabilities that will help protect margins. This is, in a sense, a back-to-basics approach, but with a twist: banks need to use the latest tools and technology to bolster their fundamental strengths.

The battle for primacy

In recent years through 2021, given near-zero interest rates across many geographies, banks benefited from the freedom to grow their balance sheet in an almost unconstrained way. Amid changing conditions, this approach needs to be recalibrated. Now banks must focus on nurturing primary customer relationships through deeper, more meaningful engagement in order to lower their cost of funds and improve their liquidity profile. Acquiring and retaining primary relationships and deepening existing relationships will be among the most important competitive advantages in the coming years. This is not a new idea in banking, but given the current market conditions, it is emerging as the most profitable approach to growth. Primary customers are more likely to generate high-ROE fee income, lower cost of funds with primary operating accounts, and maintain longer-term relationships with a bank.

Banks can develop primacy and deepen customer relationships in today's environment with three measures: a mobile-first integrated distribution strategy, innovation in products with relationship-based incentives and integrated rewards, and hyper-personalization to foster ongoing engagement.

Mobile-first integrated distribution strategy

Distribution is the fundamental interface between retail banks and their customers across acquisition, advisory, and servicing. It plays a critical role in building customer primacy and in modulating cost to serve based on client value and channel preferences. As digital channels mature and client preferences stabilize, mobile has become the channel of choice for most daily banking activities, and, increasingly, simple product cross-sales, while branches and remote models remain critical for new-to-bank acquisition, complex lending, and advisory across most geographies. As a result, leading banks are adopting a mobile-first integrated channel distribution model[9] in which individual channels have specific roles based on customer segment and needs, with mobile acting as the orchestrator to help clients navigate to the right channel and offering key features.

When it comes to branches, most banks globally have been cutting down their physical footprint, but many are doing so without a clear strategy for balancing the cost savings and the revenue impact. The role of the branch is certainly changing, but in most regions, it remains pivotal for acquiring new customers and attracting deposit balances. According to proprietary research from Finalta by McKinsey, branches in North America accounted for 72 percent of newly acquired current accounts in 2023, representing 92 percent of new current account balances; in Asia–Pacific, the figures are 55 percent and 80 percent, respectively (Exhibit 7). These figures imply that the "quality"—or depth—of digitally acquired accounts is not yet at the level of those acquired in branches. The branch story is more complex in Europe, where nearly half (44 percent) of balances are acquired digitally, but this still leaves the majority of new current account balances coming through branches.

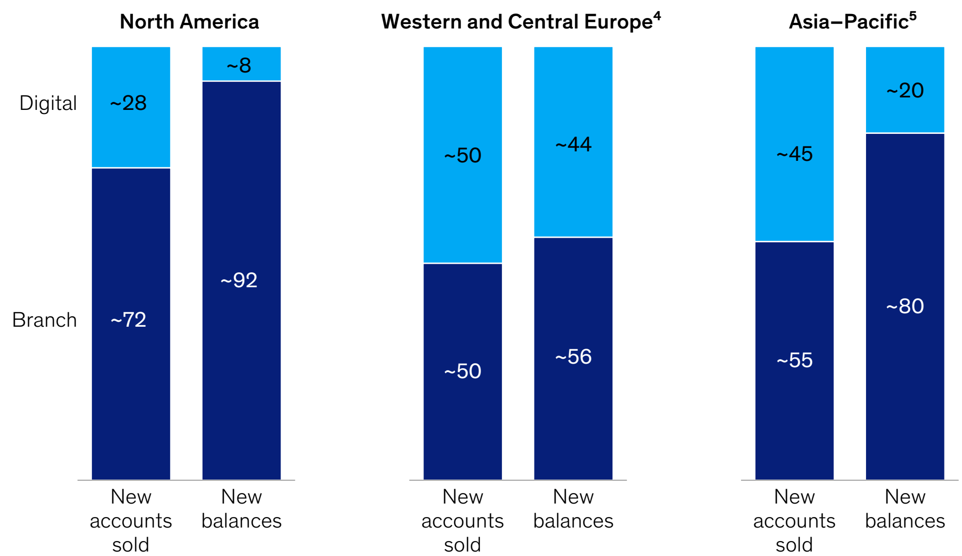
Regional and local dynamics matter, and banks must balance their distribution network to account for them, but the overall message is broadly applicable: Many customers still prefer in-person

[9] "Integrated channels: The next frontier beyond omnichannel distribution," McKinsey, May 4, 2023.

Exhibit 7

Branches still account for the bulk of new current account balances.

Current account sales mix[1] and share of new balances,[2] by acquisition channel,[3] 2023, %



[1]% of new accounts sold through branch and digital channels. [2]% of new balances = fund rate of accounts opened in channel × average balance of accounts opened in channel. [3]Branch vs digital channels. [4]Available data largely includes Central and Western Europe; sample of Southern European countries is limited. [5]Available data largely includes developed markets (eg, Australia, New Zealand, Singapore) with greater digital maturity.
Source: Finalta by McKinsey

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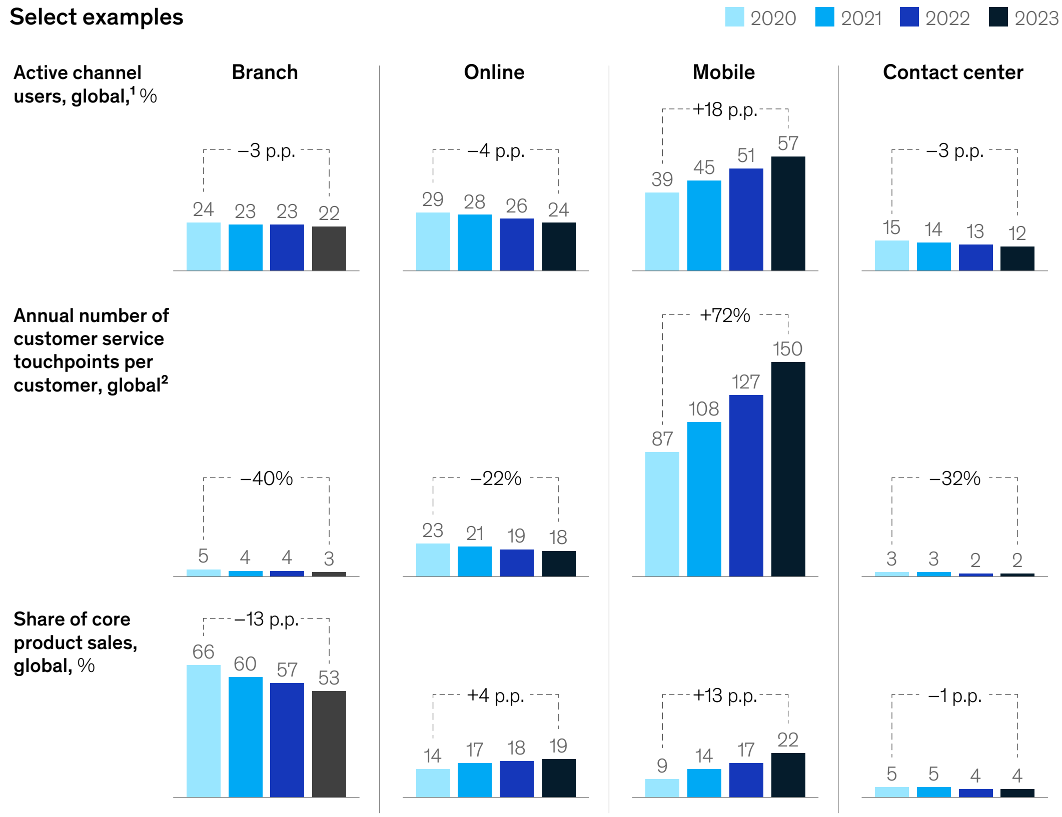
engagement for complex and consequential interactions. In our view, branches will remain an important element of retail banking distribution, especially as interest rates remain elevated and deposits a key battleground. The question banks need to answer is how to move beyond the one-size-fits-all branch format and tailor branch design—layout, services offered, level of customer support—to the local market context and strategy. Additionally, there is a growing focus on improving staff productivity and sales effectiveness, ensuring that staff spend time on proactive, value-adding activities. The core principle is that physical presence is still critical for current account acquisition and complex advice, but most daily banking activities can and should be migrated to self-serve channels.

While branches continue to play a key role, digital retail banking channels do account for a growing share of product sales, especially with regard to cross-selling of simple products like credit cards and personal loans. Digital channels are also extremely valuable for increasing customer lifetime value and boosting retention; for example, North American banks with top-quartile digital adoption—that is, customer digital usage—have half the attrition rate of less sophisticated bottom-quartile players.

Perhaps the most salient trend emerging from Finalta research is the growth in the mobile channel. Globally, the share of consumers actively using mobile for their banking needs climbed 18 percentage points between 2020 and 2023, to 57 percent (Exhibit 8). Similarly, mobile service touchpoints have proliferated over the same time period. The number of annual touchpoints grew by 72 percent, reaching 150 annual touchpoints per customer and surpassing some leading e-commerce players, suggesting that customers prefer the ease and efficiency of mobile for

Exhibit 8

Mobile adoption is growing rapidly, especially for customer service.



Note: Figures may not sum to listed totals, because of rounding.
[1]Active channel users = 90-day active channel users/active customers.
[2]For branch: payments, deposits, and withdrawals/active customers. For online: total online log-ons/active customers. For mobile: total mobile log-ons/active customers. For contact center: total inbound calls/active customers.
Source: Finalta by McKinsey

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lighter-touch interactions. Mobile's gain is, in large part, online's loss: online banking has seen an absolute decrease of four percentage points in total channel users since 2020, and customer service touchpoints declined 22 percent.

Based on this trend, banks should position the mobile channel as the primary orchestrator of consumers' interactions (Exhibit 9). Mobile thus becomes the point from which customers are steered—if needed—to the channel that best suits their needs and expectations. Banks need to invest in a seamless mobile user experience that adds structure and clarity to their journey, rather than overwhelming the customer. There is clear evidence from Finalta that leaders in mobile are now leading in retail banking overall: they outgrow the competition, have lower cost to serve, and deliver superior customer experience.

As an example of the impact of a mobile-first integrated channel strategy, we have seen retail banks fuel a 10 to 15 percent increase in deposit balances by optimizing distribution strategies within and across channels. One US bank we worked with, by identifying bottlenecks in its digital application process and improving drop-off rates for each step of the deposit funnel, boosted

Exhibit 9

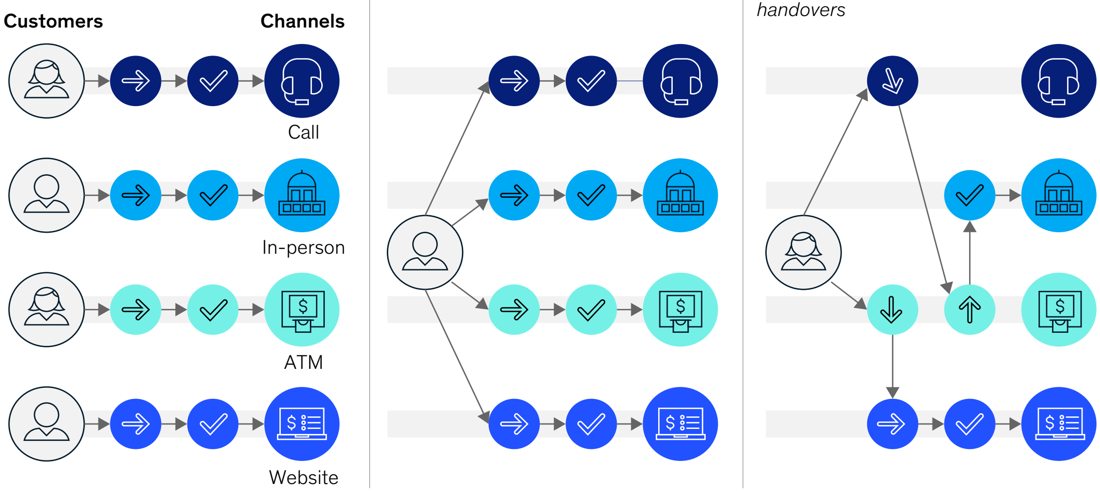
Banks can use mobile to orchestrate and coordinate customer journeys across channels.

Channel strategy archetypes

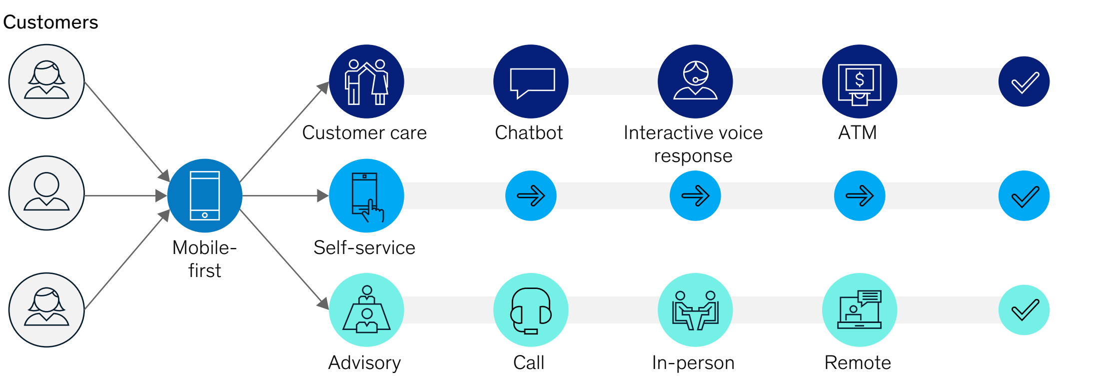
Single channel
Each customer segment has access to 1 channel

Multichannel
Each customer segment can access the bank through multiple channels, but channels are not connected

Omnichannel
Each customer segment can access the bank through multiple channels with channel orchestration and seamless handovers



Mobile as the relationship orchestrator
One primary channel (mobile) serves as starting point for all customer journeys and orchestrates interactions with other channels



Source: McKinsey

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pull-through rates across both digital and branch channels. Mastering this channel orchestration is becoming a key competitive advantage for banks seeking to boost client primacy, contain technology investment, and rightsize their cost to serve.

Innovation in relationship-based incentives and rewards

Relationship- and rewards-based strategies are an effective tactic that banks often use to deepen relationships and guard against competition from digital attackers. Leading banks are increasingly providing three types of benefits to reward consumers with bundled product offerings:

1. *Fee or price waivers.* Waivers are the most common way to incentivize customers to use more products and services. This type of benefit gives customers discounts or free products and services—for example, a premium credit card or free ATM withdrawals outside of network—based on the number of product relationships they have with the bank.

2. *Accelerated rewards.* Here, customers who have deeper and broader relationships with the bank—say, an investment account and a mortgage—are given access to accelerated proprietary rewards programs (for example, a 25 percent accelerator on certain credit card purchase categories). Such rewards can be from within a bank's internal ecosystem or part of an external program, such as airline points.

3. *Nonbanking benefits.* Some banks are going a step further by offering lifestyle benefits unrelated to banking, often as part of a broader strategy to become more central in the lives of their customers. These benefits include access to hard-to-obtain tickets or cultural experiences, "free" entertainment passes, and exclusive invitations.

Rewards and benefits are, of course, not new. Banks and particularly payments providers have been offering them for years. But given the competitive landscape, they are becoming more central to banks' tactics to deepen relationships and increase primacy. According to McKinsey's most recent Consumer Banking Value Proposition Survey,[10] customers are highly responsive to incentives of these kinds when considering deepening their relationships through bundled product offerings. For example, we found that there was a more than 60 percent likelihood of a customer signing on to a bundle combining a credit card, savings account, and checking account when the bank waived monthly checking account fees.

As is often the case, a one-size-fits-all approach will not capture the full potential. Rewards packages should be crafted to capture the nuanced needs of target segments. For example, according to the same survey, only 28 percent of US baby boomers indicated they would sign up for checking, savings, and credit card bundles with waivers of late-payment fees, compared with 58 percent of millennials. Banks should iterate on their rewards strategy through a systematic test-and-learn approach—not only tailoring benefits and bundles to priority segments but also developing discrete approaches for each stage of the customer journey (that is, from acquisition to deepening to retention). At the same time, to ensure that such programs deliver value, banks should rigorously assess the cost versus benefits; it is difficult to backtrack on benefits without compromising customer experience.

Double down on hyper-personalization

Consumer expectations for personalized experiences continue to climb as fast as digital leaders can match them. According to McKinsey research, roughly three out of four consumers report feeling frustrated when the website content of the brands they frequently interact with is not personalized. Fortunately for banks, the tools and services available to meet these expectations and deepen relationships through highly personalized customer engagement are keeping pace with demand. There has been an explosion of both data and providers that specialize in helping companies deploy a more personalized engagement strategy, more granular audience targeting, and dynamic optimization of marketing content and creatives. For example, the number of marketing technology (MarTech) providers and solutions has roughly doubled in the United States in the last five years, according to one source.[11]

Banks own more customer data than companies in most other industries, but they are behind many other consumer-facing sectors when it comes to personalization at scale. Banks seeking to unlock

[10] September 2023.
[11] *ChiefMartec Blog,* "2024 Marketing Technology Landscape Supergraphic," blog entry by Scott Brinker, May 7, 2024.

the full potential of personalization can focus on five key priorities:

1. *Identify and prioritize use cases based on value.* Banks need to understand their customers' life cycle in a granular way—particularly which moments in the journey most influence decisions about financial products. A first step is to identify the most relevant personalization use cases and assess the potential value of investing in them.

2. *Rapidly activate and optimize at scale.* The landscape of potential channels and touchpoints through which customers interact with their bank is becoming increasingly complex, which makes personalization challenging to deploy consistently. AI-driven decisioning, dynamic content, and measurement of results can enable activation of consumers across channels and touchpoints.

3. *Deploy MarTech and data enablement.* A fit-for-purpose MarTech stack with 360-degree data connectivity is required to power the analytics engine.

4. *Develop an agile operating model for personalization.* Set in place a rapid test-and-learn engine with cross-functional talent, and an agile operating model to support speed and quality of impact.

5. *Build capabilities.* Focus on talent development to sustain impact over time. Capabilities that will be in great demand include digital acumen, agility, and analytics skill sets.

The impact of putting these priorities into practice can be significant. One Western European bank we worked with deployed more than 100 personalized campaigns powered by AI. The result was an increase in conversion rates of three to five times; meanwhile, campaign durations compressed from several months to less than four weeks.

The application of gen AI tools can further boost the power and scalability of personalization, enabling banks to deploy an end-to-end engine that uses bespoke imagery, subject lines, and language to personalize touchpoints with customers at scale. However, many risks are still associated with deploying gen AI capabilities with customers. Most banks still keep a human in the loop in these interactions. However, the pace of technological development and risk controls indicates that the point where banks can truly reap the full potential of gen AI tools is not so distant. Banks need to be prepared for this moment, but most still have gaps in their data foundations that would hinder their efforts.

Protecting against margin compression with digital, AI, and gen AI capabilities

As retail banks face headwinds from a host of cost pressures and can no longer rely on a supportive macroeconomic environment to fuel outsize growth, it becomes more important to look closely at where they can better manage their margins. We see three key areas of focus that will set leading banks ahead of the pack: next-generation analytic capabilities to protect revenue margins on the deposits and assets sides, a holistic approach to fraud that balances prevention with a bank's growth strategy, and proactive adoption of gen AI tools to boost productivity.

Next-generation analytic capabilities for deposits and lending

Given the uncertain interest rate environment and volatile deposit landscape, retail banks will need to take a closer look at their pricing strategies and elevate their analytical sophistication and agility when it comes to pricing on both the asset and liability sides.

Deposits

Deposits will continue to be a crucial battleground for retail banks. As interest rates are plateauing or coming down across regions, most banks are facing questions such as these: "What term should I offer to customers on term deposits without knowing how the central bank will set interest rates?" "How should I tailor my strategy based on retention risk of a customer?" "How do I empower the front line to make the right decisions?"

To address these questions, banks need a tool kit for pricing with precision and building deeper visibility into their customer base. The following tools can help banks achieve best-in-class deposit pricing and retention management:

1. *Dynamic and personalized pricing strategy.* Banks should develop a relationship-based strategy that targets newly acquired and long-standing customers separately (for example, based on price sensitivity) and empowers the front line to take a personalized approach based on specific customer attributes (for example, transaction history) by providing them with real-time deposit product offers for clients.

2. *Customer balance sheet visibility.* Banks should identify the data required to enable a near-real-time 360-degree customer view, including transaction flows, demographics, and key churn events. This will help banks understand and act on critical moments for deepening relationships—for example, when a customer receives a job promotion.

3. *Advanced deposit modeling.* Leading banks will build analytics capabilities that support a fact-based execution of their overall deposit strategy. For example, bespoke deposit models can test price elasticity at the relationship level or balance the trade-off between getting better rates and growing deposit volume.

4. *Unified operating model.* To win the battle for deposits, banks must ensure they are coordinated across the organization—from finance to the front line—and have a governance model that allows for dynamic deposit management. For example, banks can refine frontline scorecards to incentivize accurate execution of the overall deposit strategy.

5. *Rapid decision support.* Leading banks will put in place the capacity to track the effectiveness of promotion and marketing campaigns on a daily and weekly basis. With this capability, leaders can make fact-based decisions and set strategy accordingly.

Lending

Improving pricing on the liability side is only half the battle. Many retail banks still lack a modern pricing strategy when it comes to consumer lending products. Instead, they revert to tactical pricing adjustments based on the competition, as opposed to truly understanding price sensitivity and the long-term value of their customers. Analytics leaders will take advantage of the higher (and potentially more volatile) interest rate environment to improve their lending margins based on a deeper understanding of their product economics, refining their view of the customer and their risk profile. Most capabilities described in the deposit section apply to lending as well.

For example, some banks are already experimenting with AI capabilities applied to cost-of-risk adjustments and customer elasticity. In our experience, using a vast set of parameters from transaction history (for example, cash withdrawals, activity with competitor banks), channel data (for example, frequency of mobile interactions), and credit bureau data (say, number of financial institutions where the customer applied for a loan in the past), banks can accurately assess price elasticity for loans and use it to guide pricing at an individual level.

Holistic approach to fraud

Most banks still see fraud management as a pure trade-off on the curve between revenue or customer experience and losses, tightening or loosening controls as they see fit. Given the growth in fraud, banks will need to shift that curve and minimize the trade-offs. To do so, they need a comprehensive, end-to-end approach across prevention, detection, and resolution—and, importantly, a system that guards against losses while setting an appropriate risk appetite and supporting healthy revenue growth (Exhibit 10).

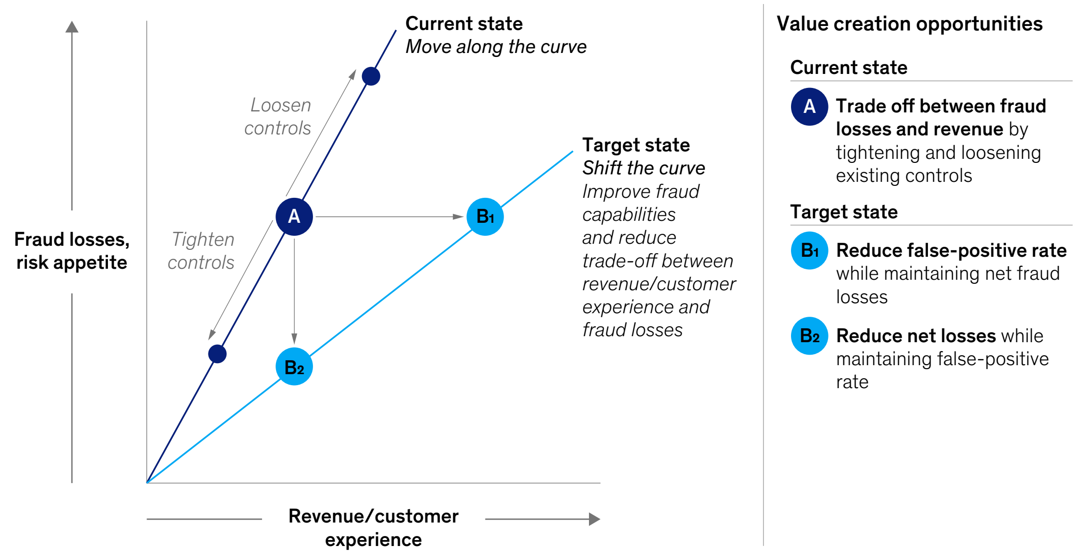
A series of actionable levers can enable retail banks to take a more resilient and proactive approach:

1. *Look beyond fraud losses*. Fighting fraud in the current environment requires that most banking executives make a significant shift in mindset. Enhancing mitigation is no longer

Exhibit 10

By taking a holistic approach to fraud, banks can reduce losses while increasing revenue.

Illustrative value creation opportunities



Source: McKinsey Risk Practice

McKinsey & Company

synonymous with tightening controls. Banks that tailor their fraud prevention systems to limit false positives (for example, through enhanced identity checks) can enjoy a significant revenue impact. For example, the impact from preventing revenue leakage due to false positives can be three to four times greater than the impact of preventing fraud by tightening controls.

2. *Set an acceptable risk appetite.* Very few banking executives have set a level of fraud losses that they deem acceptable as they seek to balance revenue growth and business strategy with prevention. Only by setting appropriate thresholds can banks measure fraud accurately and consistently, which enables active target setting and monitoring. Dashboards and analytics can provide a single integrated view of fraud losses, customer experience, and revenue impact to support decision-making by cross-functional teams.

3. *Take an end-to-end approach aligned with product strategy.* Banks can fight fraud using a mix of prevention, detection, and resolution strategies. But very few are calibrating fraud enhancement strategies with their broader business objectives. For example, a recently launched fintech with a valuation driven by its number of users might consider a more lenient approach to letting new entrants into their ecosystem but be more stringent in fighting fraud at the transaction level. By taking an end-to-end view of the solution set (for example, bespoke models for first-party fraud, transaction limits based on risk segments, direct authentication), banks can find the optimal fraud-fighting strategies to support their business objectives.

4. *Streamline fraud operations.* Finally, banks can improve their fraud approach by calibrating resources with their overall portfolio risk profile. For example, if a bank has

decided to loosen controls as part of a customer acquisition campaign, it could simultaneously scale up its fraud operations team to prepare for a spike in case volume. Operational alignment is especially important as banks invest more heavily in fighting fraud.

One regional bank we worked with recently overhauled its fraud management capability by identifying operational improvements across alert review, investigation, and resolution. After benchmarking against peers and designing a range of enhancements to bring the process up to industry standard, the bank built an automated tool to support analyst review of fraud alerts. As a result, process efficiency has increased by 35 percent (for example, through demand management), and thanks to improved onboarding and authentication, fraud losses have declined by roughly 45 percent overall.

Proactive adoption of gen AI

Gen AI is rapidly reshaping productivity[12] in the financial services landscape. For retail banks, most use cases with sufficient maturity center on developer productivity and operations, but future applications will span a much broader spectrum and likely include areas such as product design. Today, four domains are emerging as initial gen AI focus points for banks:

1. *Contact centers.* In contact centers, gen AI has proven its capability to improve the quality of customer interactions and boost efficiency. Leading banks are testing gen AI's capacity to deliver value in contact centers and through the use of virtual assistants—AI "copilots"—to offer real-time suggestions for script generation based on rapid customer profiles. Other emerging use cases include call analysis and coaching for call center agents and advisors. Some banks are also exploring opportunities to deploy AI-powered chatbots. By our estimate, these applications have the potential to drive down human interaction costs by roughly 10 to 25 percent.

2. *Operations and technology.* On the operations and technology front, gen AI can reduce costs for a wide range of back-end processes, using automation to replace "manual" labor (thereby freeing up time for employees to focus on more value-added tasks) and accelerate time to completion. As an example, gen AI could be used to clean-sheet a mortgage appraisal review and write-up process, searching for comparable properties and comparing them based on rules (in the appraisal report process), and synthesizing findings. By ingesting key data inputs at several points in the appraisal process, gen AI capabilities could significantly accelerate an otherwise manual and operationally burdensome process.

3. *Legal, risk, and fraud.* In the area of legal, risk, and fraud, gen AI will have a significant productivity impact on activities requiring document interpretation and text generation. Approximately 10 percent of an average retail bank's staff are dedicated to legal and risk functions, and these resources are allocated to activities like refining and implementing risk model documentation and fraud detection and reporting. Given the nature of these activities and processes, the use cases for legal and risk functions are wide-ranging; examples include drafting suspicious-activity reports based on recent customer transactions and automated monitoring of regulations to scan for updates and compare against internal processes. Leading players are deploying capabilities that reduce document generation costs by 35 to 40 percent.

4. *Talent management.* Finally, retail banks can utilize gen AI to create efficiencies for their talent functions and improve the productivity of their existing workforces. With respect to hiring, banks can leverage gen AI to create job descriptions and postings, screen candidates' résumés and applicant responses, draft interview questions, develop targeted recruiting content to reach specific applicant

[12] "Scaling gen AI in banking: Choosing the best operating model," McKinsey, March 22, 2024.

pools (for example, university students seeking internships), and create a self-serve employee onboarding experience. Similarly, algorithms can generate educational content in text, photo, and video formats to bolster workforce training and development. We see an opportunity for 20 to 35 percent of productivity potential in talent development that could be realized through these capabilities.

Piloting and deploying early gen AI use cases does not come without risk. Gen AI is opening the door for new dimensions of risk (for example, hallucinations, regulatory complexity, responsible AI), but new governance and technology solutions (watermarking, data sequestration) are already emerging to manage these. Banks need to take a thoughtful approach that balances cost and operational upside with potential risks while investing in new risk mitigation strategies to lay the groundwork for broader, longer-term adoption.

As we near the completion of an upbeat chapter in retail banking, leaders will begin now to set a clear agenda for competing in a more constrained and competitive environment. History shows that when the going gets tough, opportunities for outperformance and growth abound. For banks, the imperatives are clear: rapidly develop the tools, skills, and capabilities to boost primacy with value-generating customers and protect margins by investing in digital and AI capabilities that support deposit growth, pricing, and fraud management, among other needs. Banks that focus with laser intensity on these points will turn the page on a bright future.

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